FRANCHISE REGULATION: OHIO CONSIDERS LEGISLATION TO PROTECT THE FRANCHISEE

On May 11, 1971, Senate Bill 295 was introduced in the 109th General Assembly of the State of Ohio.[1] As a disclosure type proposal, Senate Bill 295 is designed to protect the prospective franchisee from material omissions of fact by franchisor-sellers. While the Ohio Division of Securities is given the primary enforcement responsibility, perhaps the most important aspect of this legislative proposal is that it establishes a private cause of action for anyone injured from acts in violation of the statute. The Ohio proposal comes at a time when the franchising system of marketing is the target of numerous legislative attempts to free the area of abuses. Although the federal government has yet to enact proposed legislation to regulate the sale of franchises, several states have either enacted or are now considering legislation to protect the franchisee.[2] The possibility of a preemptive federal statute also raises doubts as to whether the states should individually legislate to protect the franchisee. This article will briefly view the abuses associated with the sale of franchises and the movement toward disclosure statutes to remedy the problem. The Ohio proposal will be considered in detail. Senate Bill 295 is substantively similar to legislation being considered in several states and is virtually a verbatim copy of the recently enacted California disclosure statute. Major problems arise both during the franchise term and upon termination of the contract which are not affected by disclosure requirements. These problem areas will be considered in Part IV. Although Ohio has not yet considered legislative action to correct abuses beyond the initial sale, several proposals have received serious attention in other jurisdictions.

I. INTRODUCTION

Although franchising is not a new form of marketing goods and services,[3] the franchise distribution system has experienced a phenomenal

[1] Ohio S.B. 295, 109th Gen. Assembly, Reg. Sess. (1971). S.B. 295 was referred to the Senate Commerce and Labor Committee on May 12, 1971.

[2] At least eight states and Puerto Rico have enacted legislation regulating various aspects of the franchise relationship. *See* California Franchise Investment Law, CAL. CORP. CODE §§ 31000-31516 (West Supp. 1971); Delaware Security for Franchise Distributors, 6 DEL. CODE ANN. §§ 2551-2557 (Supp. 1970); New Jersey Franchise Practices Act, 56 N.J. STAT. ANN. § 10, (Supp. 1972). An Act Relating to Franchisees and Distributorships, 3 FLA. STAT. ANN. SESS. LAWS, Chapter 71-61 (West 1971) (Florida); Arkansas Act Making it Unlawful to Discriminate Against Arkansas Franchisees and for Other Purposes, Arkansas General Assembly Act 252 (1971); Puerto Rico Dealer's Act, 10 L.P.R.A. §§ 278a-d (Equity Supp. 1971); Franchise Investment Protection Act, WASH. LAWS, ch. 252, 42d Legis., 1st Sess. (1971), *as amended*, WASH. LAWS, ch. 116, 42d Legis., 2d extra Sess. (1972); Wisconsin Franchise Investment Law, WISC. LAWS, ch. 241, 80th Reg. Sess. (1972).

[3] H. KURSH, THE FRANCHISE BOOM 5-6 (1968), [hereinafter cited as H. KURSH]. The Coca-Cola franchise in Georgia was established in 1901; Rexall Drug Stores was in exis-

growth in recent years.[4] The franchise system has been acclaimed as the most viable means of maintaining the existence of the small business entrepreneur.[5] The system has also been noted as a vehicle to open business opportunities to women and minority groups.[6] The franchisor and the franchisee obtain great benefits from the nature of the system. The franchisor is able to develop a vast system of distribution for his product at a lower cost than if he were to attempt to finance and operate the system individually. The franchisee is able to compete more effectively with wholly owned chains because he obtains the backing of an organization which is able to provide varied technical assistance and the economies of a mass operation. The franchisor's image, tradename and system give the local franchisee the benefit of large-scale advertising and a basis for consumer acceptance.

Because of the nature of the franchise system, the franchisor retains a great degree of control over the franchisee. The former has a legitimate desire to maintain a certain level of product quality among all outlets. Since the franchise is largely premised upon the concepts of referral business and national advertising, the consumer expects to receive the same quality product from each franchisee.[7] Many franchisors, however, abuse this legitimate concern for a standard quality by requiring the franchisee to purchase equipment and supplies at exorbitant prices. Such requirements have been the subject of successful lawsuits against franchisors based upon antitrust theories.[8] Franchisors may also require overly strict operating procedures and policies in their attempt to enforce a standard quality, with the violation of any contractual term giving the franchisor cause to terminate the franchise relationship. Harold Brown, a leading commentator

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tence in 1902. Western Auto Supply Company started franchising in the early 1930's and now supports over 4,000 independently owned franchised outlets.

4 By 1970, the franchise system accounted for $90 billion in annual sales or 10 percent of the gross national product. Over 25 percent of all retail sales are now attributed to franchised outlets. *Hearings on the Impact of Franchising on Small Business Before the Subcomm. on Urban and Rural Economic Development of the Senate Select Comm. on Small Business*, 91st Cong., 2d Sess., at 1 (1970) [hereinafter cited as *1970 Hearings*]. *See also* BURCK, *Franchising's Troubled Dream World*, FORTUNE, March 1970, at 118.

5 *1970 Hearings, supra* note 4, at 49. The courts have also acclaimed the franchising system as the savior of small business. One federal district court stated:

> The franchise method of operation has the advantage, from the standpoint of our American system of competitive economy, of enabling numerous groups of individuals with small capital to become entrepreneurs. . . . If our economy had not developed that system of operation these individuals would have turned out to have been merely employees.

Susser v. Carvel Corp., 206 F. Supp. 636, 640 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965).

6 H. KURSH, *supra* note 1, at 135-61. *See also* Sayre, *Franchising in the Ghetto*, 25 BUS. LAW. 73 (Special Issue 1969).

7 H. KURSH, *supra* note 1, at 46.

8 *See, e.g.*, Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965); Dehydrating Process Co. v. A. O. Smth Corp., 292 F.2d 653 (1st Cir. 1961), *cert. denied*, 368 U.S. 931 (1961).

on the subject, has succintly explained the nature of the control which the franchisor may have over a franchisee as follows:

> There is a marked, intentional, and constantly emphasized disparity in the positions of the parties—the franchisor combining the roles of father, teacher, and drill sergeant, with the franchisee relegated to those of son, pupil, and buck-private, respectively. At the core of the franchise relationship is the contractual control exercised by the franchisor over every aspect of the franchisee's business. Starting with the advertisement which calls for "no experience," the franchisor inculcates the franchisee with the necessity of being taught, guided, and controlled not only during the initial training period but throughout the existence of the franchise. The franchisor controls the site, commissary purchases, purchases from other vendors, method of business operations, labor practices, quality control, merchandising, and even record keeping. This control is buttressed by the contractual requirement that the franchisee must obey the commands of the Operating Manual as expounded by the franchisor's supervisor, on pain of losing the franchise if he disobeys them and under constant threat of such termination. And upon termination, or failure to renew, the franchisee is confronted with the covenant not to compete and forfeiture of his equity in the business.[9]

The picture of the strong franchisor and the weak franchisee is aggravated by the mere fact that the former has a substantial economic advantage in most instances. The franchisee has very often committed his total savings to the franchisee fee and other necessary start-up costs. The franchisor, in the meantime, is holding the franchise fee which is often substantial. This marked economic advantage gives the franchisor a very real opportunity to coerce the franchisee to accede to the former's demands.

The abuses associated with the franchise relationship can easily be confronted at three "chronological" points:

(1) false and deceptive statements and material omissions by the franchisor in the offer of sale;
(2) restrictive terms and unequal bargaining position during the term; and
(3) unjustified termination or refusal to renew the franchise agreement during or at the end of the term.

The regulation of the franchising industry which requires full disclosure has received the most attention from legislators and commentators. The franchise situation today is somewhat analagous to the status of the securities industry prior to enactment of federal and state laws requiring full disclosure to the prospective investor. One state investigation concluded

[9] H. BROWN, FRANCHISINGS TRAP FOR THE TRUSTING 41 (1969) [hereinafter cited as BROWN]. The basic abuses which Mr. Brown refers to have been verified by hearings conducted in several jurisdictions. *See, e.g., 1970 Hearings, supra* note 4; Clurman, *A Report to the Honorable Louis J. Lefkowitz, Attorney General of the State of New York, on Franchising,* (Jan. 7, 1970) [hereinafter cited as *N.Y. Att'y Gen. Rep.*]; *Interim Hearing on Franchises before the Senate Insurance and Financial Institutions Committee,* in Sacremento, California (Nov. 7, 1969) [hereinafter cited as *Interim Hearing*].

that the typical franchise offer "is either grossly inadequate, misleading, insubstantial or non-existent as to material facts, and in general presents a danger to the investing public."[10] Among the major areas which may be the subject of misrepresentation in franchise offerings are the investment requirements of the franchisee, the earnings projected by the offeror, the assistance to be given the franchisee, and the background of the franchisor. Each of these items will be discussed below as they relate to Ohio Senate Bill 295.

Whereas disclosure legislation does not affect directly the contract itself, legislation which regulates the bargaining positions of the parties and the termination rights of the franchisor directly negates the contract terms. The obvious response from those who oppose legislation to correct such abuses is that freedom of contract should prevail. The contemporary viability of this argument can be seriously questioned when one considers the numerous federal and state laws which have been enacted to override contractual provisions. The nature of the legislative proposals to correct the abuses associated with termination and bargaining position will be discussed in Part IV.

II. FRANCHISE DISCLOSURE LEGISLATION

A. *Attempts to Use Existing Security Laws*

The proposals for regulating the sale of franchises by means of legislation requiring disclosure similar to existing securities laws is largely an outgrowth of debate as to whether a franchise agreement is within the meaning of "security" under the various securities laws.[11] Those who favor the classification of the franchise agreement as a security argue that the franchisor is seeking investment capital and should be subject to the same statutory regulations which govern the sale of traditional forms of securities.[12] Although the franchise agreement and certain types of securities have many common features, the courts have been generally unwilling to extend the anti-fraud provisions of the securities laws to benefit franchisees.

Much of this debate centers on the application of the holding in *SEC v. W. J. Howey Co.*[13] where the Supreme Court was concerned with the meaning of an "investment contract" which is one of the terms defined as

[10] *N.Y. Att'y Gen. Rep.*, *supra* note 9, at 2.

[11] *See, e.g.*, Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1970); OHIO REV. CODE ANN. § 1707.01 (Page Supp. 1971).

[12] *See* Goodwin, *Franchising in the Economy: The Franchise Agreement as a Security Under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969); Augustine & Hrusoff, *Franchising Under the Securities Act of 1933 and the California Corporations Code*, 44 LOS ANGELES B. BULL. 555 (1969); Coleman, *A Franchise Agreement: Not a "Security" Under the Securities Act of 1933*, 22 BUS. LAW. 493 (1967).

[13] 328 U.S. 293 (1946).

a security by the Securities Act of 1933. Since the franchise contract is more nearly like an investment contract than any of the other listed security types, the *Howey* definition of an investment contract has been the leading one in the discussion of whether the franchisee should be accorded the protection of the securities laws. In the *Howey* decision the Court said that an investment contract for purposes of the Securities Act means:

> [A] contract . . . whereby a person invests his money in a common enterprise and is led to expect profits *solely* from the efforts of the promoter or a third party.[14]

Franchisees who attempt to avail themselves of the protection of securities laws (based on the argument that the franchise is an investment contract) will fail because of the requirement that they must rely "solely" on the efforts of the franchisor. The typical franchisee obviously does not rely entirely on the franchisor. Most of the litigants who have relied on the *Howey* test have been participants in multi-level or pyramid distribution schemes. While many courts have held that if a bare minimum of effort is required of the participant the scheme is not an investment contract, there is some recent authority that pyramid distribution schemes will be subject to security laws.[15] The federal courts have generally refused to make the federal securities laws applicable to franchise contracts.[16] In-

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[14] *Id.* at 298-99 (emphasis supplied).

[15] A variety of marketing schemes have been presented to state courts by plaintiffs attempting to invoke state securities laws for their protection. In Koscot Interplanetary, Inc. v. King, 452 S.W.2d 531 (Tex. 1970), purchasers of cosmetics distributorships could receive "finder's fees" for recruiting new distributors. The court rejected the application of the securities laws, however, relying mainly on the *Howey* test. The contract was deemed not a security because the investors did not depend solely on the efforts of others for profit. Other courts have held that individuals who had acquired purchase cards to distribute to others and who later had received a commission on sales to the card holders did not purchase a security. *See* Georgia Market Centers, Inc. v. Fortson, 225 Ga. 854, 171 S.E.2d 620 (1969); Gallion v. Alabama Market Centers, Inc., 282 Ala. 679, 213 So. 2d 841 (1968). *Contra*, Florida Discount Centers, Inc. v. Antinori, 226 So. 2d 693 (Fla. 1969). In Emery v. So-Soft of Ohio, Inc., 94 Ohio L. Abs. 357, 199 N.E.2d 120 (Ct. App. 1964), the court held that a referral agreement whereby a seller of water conditioners agreed to pay buyers $100 for each name furnished by the buyer resulting in a subsequent sale not a security. The court pointed out that the buyer had to earn the commission by taking positive action, and thus could not rely solely on the efforts of the seller. One year earlier a common pleas court in Ohio had decided otherwise in a case involving the same water conditioner seller. Yoder v. So-Soft of Ohio, Inc., 94 Ohio L. Abs. 354, 202 N.E.2d 329 (C.P. 1963). The Pennsylvania Supreme Court has come to the conclusion reached in *Emery* by applying the *Howey* test. Commonwealth ex rel. Pennsylvania Securities Comm'n v. Consumers Research Consultants, 414 Pa. 253, 199 A.2d 428 (1964). With the heavy reliance on the *Howey* test in the state courts, it seems doubtful that the typical franchise agreement will be held to be a security since the franchisee is actively involved in the operation of the overwhelming number of franchises.

[16] At last one federal appellate court has decided that a typical franchise agreement is not a security under federal law. In Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635 (9th Cir. 1969), the court followed the *Howey* test in deciding that a franchise agreement, whereby the distributor paid a $5,000 fee for the right to market a product, was not a security. Although the advertisements for the sale of the franchise stressed that minimum effort was required of the distributor, the court found that the distributor did not rely solely on another's

deed, there is some evidence that the Securities and Exchange Commission would oppose any definition, whether by the courts or by amendment to the existing law, which would make most franchise agreements "securities."[17]

The "definitional" court battle will no doubt continue in those jurisdictions where legislation is not enacted to regulate franchise sales. The advent of disclosure legislation, however, may soon render the "franchise-security" issue moot in a number of jurisdictions.

B. *Legislative Action*

Much of the debate over whether a franchise contract is a security was spearheaded by a 1967 opinion of the California Attorney General which stated that the sale of a franchise in certain instances is the sale of a security.[18] The net result of this opinion and the resulting application of the California securities laws to franchise contracts was confusion.[19] To remedy the situation, the Commissioner of Corporations called for the drafting of specific legislation to require disclosure in the sale of franchises.[20] An investigation of franchising by a California Senate Committee[21] provided the basis for the resulting Franchise Investment Law.[22] This

efforts. *See also* Drug Management, Inc. v. Dart Drug Corp., 1961-64 CCH FED. SEC. LAW REP. ¶ 91,293 (D.D.C. 1962). *See generally*, Goodwin, *Franchising in the Economy: The Agreement as a Security Under the Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969); Coleman, *A Franchise Agreement: Not a "Security" Under the Securities Act of 1933*, 22 BUS. LAW. 493 (1967).

17 On the contrary, "if disclosure is to be obtained in the franchising area, this should be by the enactment of *separate legislation* rather than . . . by simply changing the definition of security in the Securities Act so as to make a franchise a security thereunder." Statement of Philip A. Loomis, Jr., General Counsel, Securities and Exchange Commission, in *1970 Hearings, supra* note 4, at 706 (emphasis supplied). The SEC has recently issued a release regarding the application of the federal securities laws to the multi-level distributorship and pyramid sales plans. Securities Act of 1933, Release No. 5211, Securities Exchange Act of 1934, Release No. 9387, (November 30, 1971). The Commission's view is that certain pyramid schemes are inherently fraudulent and that the antifraud provisions of the securities laws will be used to benefit prospective investors in such sales promotions. The SEC release agreed with the Supreme Court of Hawaii which held that the broad protection of the securities laws should be accorded investors even where the investors participate to a limited degree. State v. Hawaii Market Center, Inc., 485 P.2d 105 (Hawaii 1971). Thus, the strict test developed in *Howey*, that the profits must come "solely from the efforts" of others, may no longer protect certain schemes of marketing distributorships from the securities laws.

18 49 OPS. CAL. ATT'Y GEN. 124 (1967). The opinion was largely based on the "risk capital" theory developed by the Supreme Court of California in Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). If the franchisor secured a substantial percentage of his risk capital from franchise fees, the franchise was a security (specifically an investment contract) for purposes of the California securities law. CAL. CORP. CODE § 25019 (West Supp. 1971). For an excellent discussion of the opinion, *see* Augustine & Hrusoff, *Franchise Regulation*, 21 HASTINGS L.J. 1347, 1353-64 (1970). *See also* Note, *Franchise Regulation Under the California Corporate Securities Law*, 5 SAN DIEGO L.R. 140 (1968).

19 Pierno, *Franchise Regulation—The Need for a New Approach*, 44 LOS ANGELES B. BULL. 501 (1969).

20 *Id.* at 535.

21 *Interim Hearing*, note 9 *supra*.

act, used as a model for the Ohio proposal, has been acclaimed as "the first major piece of legislation aimed at protecting the consumer from unethical franchising techniques and practices."[23]

The possibility of federal legislation complicates the issue as to whether the state legislatures should enact disclosure requirements at this time, but to date, only two federal proposals have received actual consideration. After extensive hearings,[24] the "Franchise Full Disclosure Act of 1970" was introduced by Senator Williams.[25] This bill required registration with the Securities and Exchange Commission [hereinafter SEC] as well as disclosure of material facts to the prospective franchisee. The disclosure requirements were essentially the same as those proposed by Ohio Senate Bill 295,[26] however, unlike the existing security registration and disclosure acts, the Williams proposal would have granted triple damages to the injured franchisee.

Perhaps the crucial threshold issue of "who" should regulate has resulted in reluctance on the part of some legislative bodies to proceed with a regulatory program. The "Franchise Full Disclosure Act of 1970" specifically refrained from preempting state legislation,[27] but the franchisors are on record as favoring only federal legislation if it is determined that any legislation is necessary.[28] The franchisor's argument is that, practically, it will be nearly impossible to comply with different state statutes simultaneously. Although uniform state laws are a possible alternative, the likelihood of any movement in this direction would probably take many years.

Although the "Franchise Full Disclosure Act of 1970" was not reported out of committee,[29] Senator Williams introduced another disclosure proposal in 1971.[30] The 1971 proposal would be preemptive, thus resolving the fears that the various state enactments would be so different as to make compliance difficult, if not impossible. The most recent proposal by Senator Williams also differs substantively in its regulatory scheme.

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22 CAL. CORP. CODE §§ 31000-31516 (West Supp. 1971).

23 CONTINENTAL FRANCHISE REV, Aug. 10, 1970, at 3.

24 *1970 Hearings*, note 4 *supra*.

25 S. 3844, 91st Cong., 2d Sess. (1970).

26 *Id.* § 7. *See* Appendix A.

27 *Id.* § 11. Jurisdiction provisions also denied removal to a federal court if the action was commenced in a state court of competent jurisdiction. S. 3844, 91st Cong., 2d Sess. § 18 (1970).

28 *Statement on Behalf of the International Franchise Association Before Federal Trade Commission Hearing on Proposed Trade Regulation Rule*, by Philip F. Zeidman, General Counsel, International Franchise Association, Feb. 14, 1972, on file in the office of the Ohio State Law Journal.

29 Many prior federal attempts to legislate in the franchising area were similarly unsuccessful. *See* Zeidman, *Legislative Supervision of the Franchise Contract: Throwing Out the Baby with the Bath Water?*, 15 N.Y.L.F. 19 (1969).

30 S. 2399, 92d Cong., 1st Sess. (1971). This bill was introduced on August 2, 1971.

The Federal Trade Commission [hereinafter referred to as FTC], rather than the SEC, would be given the power to promulgate regulations relative to disclosure. Any failure to comply with the regulations would be a violation of § 5 of the FTC Act,[31] and the franchisee would be given a private cause of action for treble damages. This proposal would be the first departure from the existing norm under § 5 which, presently, does not provide for private actions.

Perhaps in anticipation of the enactment of Senator Williams' 1971 proposal, the FTC recently held hearings on a Trade Regulation Rule which would require disclosure by franchisors.[32] The disclosure requirements are substantially identical to the California Franchise Investment Law and the Ohio proposal. Under the proposed Trade Regulation Rules, the franchisor would be required to furnish the prospective franchisee a single package of designated items of information at the first contact. In addition, the proposed rule would give the franchisee a ten day "cooling-off" period to cancel the contract with a refund of any fees paid to the franchisor. Another provision would preserve the franchisee's defenses and claims if he signed a promissory note which was subsequently assigned by the franchiser to a third party. This FTC proposal would clearly go beyond the basic disclosure requirements and give the franchisee important substantive rights. The proposed Trade Regulation Rule would provide an enforcement capability which would partially fill the void currently existing in this area, since most states have not yet enacted legislation requiring disclosure by franchisors. Perhaps the proposal will serve as a model for state disclosure legislation in the future, thereby encouraging uniformity.

The FTC proposal, however, has two major drawbacks. First, no provision is made for private actions based upon violations of the disclosure rules. Thus, while many prospective franchisees may be protected by the FTC policing effort, the injured franchisee must still resort to common law fraud and contract theories for relief. The second and more basic shortcoming of the Trade Regulation Rules is that the FTC may not have the authority to issue such regulations with the effect of law without enabling legislation. Less than two months after the public hearings on the proposed franchise disclosure Trade Regulation Rules were closed, a federal court held that the FTC Act did not confer the authority to promulgate such rules with the effect of substantive law.[33] Specific legislation, either establishing such rules directly or delegating the power to promulgate such rules to the FTC is necessary. The recent bill introduced by

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[31] 15 U.S.C. § 41-58 (1970).

[32] 16 C.F.R. 436 (1972). Hearings on the proposed rule were held on February 14-16, 1972.

[33] National Petroleum Refiners Ass'n. v. FTC, 340 F. Supp. 1343 (D.D.C. 1972).

Senator Williams would rectify the above defects.[34] Under this proposal, the franchisee is given a private cause of action based on a violation by the franchisor of the disclosure requirements. The Williams bill would specify the disclosure requirements and give the FTC the power to promulgate rules to implement and enforce the regulatory scheme.

It is obvious that the current status of federal action to regulate franchise sales is not clear. If Congress enacts a preemptive disclosure bill, the Ohio proposal would be of limited utility except, perhaps, to regulate purely intrastate franchise sales. Since the track record for federal proposals to date is not promising for the proponents of federal legislation, perhaps the best that can be achieved at this time is uniform state legislation. With this in mind, the Ohio General Assembly may find it desirable to initiate a regulatory program to protect prospective franchisees from fraud and misrepresentation. If the disclosure rules in the various states are substantially identical, the franchisor will be able to use the same basic information and data in his registration application and prospectus. The statutes may differ as to administration and remedies without casting any undue burden on the multistate franchisor.

III. THE PROPOSED OHIO DISCLOSURE BILL

A. *An Overview*

Ohio S.B. 295 is a modified full disclosure act which gives primary administrative and enforcement powers to the Division of Securities.[35] Since this state agency also supervises the Ohio Securities Act,[36] the Division arguably possesses the expertise and administrative machinery necessary to implement and administer the franchise disclosure legislation. By exempting franchises from regulation under the state securities laws,[37] S.B. 295 will effectively end the debate in Ohio on the issue of whether a franchise is within the definition of a "security."[38]

As a modified disclosure bill, S.B. 295 regulates only the initial stages of the franchise transaction; the proposal does not attempt to correct abuses which may arise during the franchise term or with termination of the

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[34] S. 2399, 92d Cong., 1st Sess. (1971).

[35] Ohio S. B. 295, 109th Gen. Assembly, Reg. Sess. (introduced May 11, 1971) [hereinafter cited as S. B. 295]. This bill, which was introduced by Senators Cook, Matia, Corts, Poda, Secrest, and Leedy, is designed to enact sections 1705.01 to 1705.38 inclusive, and 1705.99, and to amend sections 1707.03, 1707.19, 1707.46, and 4735.18, relative to the sale of franchises. The proposal is substantially identical to the California Franchise Investment Law, CAL. CORP. CODE §§ 31000-31516 (West Supp. 1971).

[36] OHIO REV. CODE ANN. § 1707.23 (Page 1964).

[37] S.B. 295 § 1707.03(T).

[38] OHIO REV. CODE ANN. § 1707.01 (Page Supp. 1971). *See* Emery v. So-Soft of Ohio, Inc., 199 N.E.2d 120 (Ohio Ct. App. 1964); Yoder v. So-Soft of Ohio, Inc., 94 Ohio L. Abs. 354, 202 N.E.2d 329 (C.P. 1963). *See generally* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 Case W. Res. L. Rev 367 (1967).

contract. The mandatory disclosure scheme is designed to prevent fraud and misrepresentation by the franchisor by providing the prospective franchisee with the data necessary to make an informed decision whether to execute the franchise agreement.[39] Disclosure is accomplished by requiring the franchisor to file an application for registration of the offer to sell a franchise with the Division of Securities. Disclosure of specified facts must be included in the application, and a prospectus, containing the same information, must be delivered to the prospective purchaser prior to execution of the franchise contract. Registration is effective for one year; renewal applications must be submitted prior to the expiration of the registration.[40] All applications must be sworn to by the franchisor.[41] To ease the initial filing burden for franchisors, the applicant may incorporate by reference any document previously filed with the Division of Securities as required by the Ohio securities laws.[42]

The proposed Ohio law also limits the persons who may offer or sell franchise agreements. Three classes of salesmen are authorized:

(1) persons identified in the application;
(2) persons licensed in Ohio as real estate brokers or salesmen; and
(3) persons licensed in Ohio as security dealers or salesmen.[43]

The California drafters considered this alternative preferable to licensing individuals as franchise salesmen. The franchisor's representative, if named in the application for registration, is a qualified salesman unless the Division of Securities orders suspension of the proposed registration based upon information required to be disclosed.[44]

The proposal is referred to as a "modified" disclosure bill because it grants the Division of Securities the power to prevent varied abuses in the offering and sale of franchises.[45] The Division may, for example, issue

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[39] *See* CAL. CORP. CODE § 31001 (West Supp. 1971). S.B. 295 does not contain a similar section stating the purpose of the legislation.

[40] S.B. 295 § 1705.09. The proposed bill also imposes the following filing fees to cover the cost of administration: $200 for the initial registration, $50 for renewal applications, and $25 for filing an advertisement required to be submitted under § 1705.14. S.B. 295 § 1705.35. The implementation of the California Franchise Investment Law did not require an increase in staff of the Department of Corporations. During the first year in which the California law was effective, 246 applications for registration were filed. Letter from W. R. Barnes to the Ohio State Law Journal, Feb. 29, 1972.

[41] S.B. 295 § 1705.08.

[42] *Id.* § 1705.30.

[43] *Id.* § 1705.17. The licensing of franchise salesmen has been proposed as an alternative to the limiting of franchise salesmen which has been proposed in the Ohio bill and adopted in the California law.

[44] *See* S.B. 295 §§ 1707.06(E), 1705.11(C).

[45] There are three basic types of regulatory programs which can be utilized to control or monitor franchise offerings. First, a permit bill which completely subjects any franchisor offering his system or plan for sale within a state to the authority and discretion of the administrator of that state's law. With the permit-type program, the state can effectively prohibit any franchisor from selling in the state. Permit bills generally provide for total regulation like, for example, the system of regulating common carriers in Ohio and other jurisdic-

stop orders, require the escrow of franchise fees and prohibit deceptive advertising. In other words, the Division may take positive action to prevent abuses, rather than merely functioning as a depository of public information or as a prosecutor. The Division is given the authority to take action to protect the franchisee's investment at the initial stage of the development of the franchise contract.

B. *Which Franchisors Must Register?*

To determine which franchisors must register and disclose the required data to prospective franchisees, several sections of S.B. 295 must be considered. The definitions of "franchise" and "franchise fee" must be considered in conjunction with the more straightforward jurisdictional elements of the statute. The jurisdictional requirements are basically designed to provide protection to the franchisee domiciled in Ohio where the franchise is to be operated in Ohio. If the offer or acceptance of the franchise agreement occurs within the State of Ohio, the necessary contact with the state exists to justify the application of the law.[46] Thus, where the franchisor offers a franchise for sale, which offer is found to have been made in Ohio, the statute will apply.[47] If the offer and acceptance occur outside the State of Ohio, the statute will not apply unless the franchisee is domiciled within Ohio and the business is to be operated within Ohio. S.B. 295 will not apply to contracts executed outside the State of Ohio even where the franchise is to be operated in Ohio, if the franchisee is not an Ohio resident, because there is no justification for imposing Ohio's *disclosure* laws in a situation where the only contact with the State of Ohio is the subsequent operation of the business. The proposal also states *when* an offer or an acceptance is considered to have been made within this state.[48] The proposal exempts offers in publications where the paid circulation of the media is more than two-thirds outside the state, and radio or television offers are exempt when the programming originates out-

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tions. Second, a pure disclosure statute which may be used to compel the franchisor to provide the franchise with relevant date. The pure disclosure statute, however, does not give the state agency the authority to make a qualitative judgment as to the merits of the proposed franchise sale. Thus, the third type of regulation, the modified disclosure act, may be viewed as somewhere between the permit and pure disclosure statutes. The modified disclosure statute provides for full and adequate disclosure, but in addition the modification grants state administrators the power to prevent certain related abuses. The administration of the modified act necessarily requires the state agency to make a judgment as to the quality of the offer and the probability that the franchisor will indeed fulfill his promises to establish and support the new franchise. If the judgment is that the franchisee's interests deserve protection, then the state agency can issue various orders to protect the franchisee's initial investment.

[46] *See* McGee v. International Life Ins. Co., 355 U.S. 220 (1957); International Shoe Co. v. Washington, 326 U.S. 310 (1945).

[47] S.B. 295 § 1705.02(A).

[48] *Id.*

side the state.[49] The above jurisdictional limitations present no insurmountable problems of interpretation, but the definitions of several key terms will, undoubtedly, cause some difficulty of interpretation.

Section 1705.01 includes all definitions to be used in reference to S.B. 295. The most difficult term to define is the word "franchise" itself. The word has been used most often in a very general sense.[50] The application of the proposed bill is narrowed significantly by the definition of "franchise" and by specific exemption provisions included in the bill.

S.B. 295 defines "franchise" as an agreement, written or oral, which:

> (1) grants the right to engage in a business under a plan prescribed in substantial part by a franchisor, and
> (2) such plan is substantially associated with the franchisor's commercial symbol, and
> (3) the franchisee is required to pay a franchise fee.[51]

Note that this definition limits the application of the law to those transactions where all three of the stated elements exist. The intent is to exempt what might commonly be called a "franchise" where the agreement is merely a dealership. The normal retail dealer agreement where the retailer sells a variety of goods produced by a number of manufacturers, as an "exclusive area dealer" or an "authorized dealer," will not be subject to the proposed law because in the normal situation the dealer does not pay a franchise fee.

The definition of "franchise fee" is also intended to narrow the application of the disclosure bill. To qualify under the definition of "franchise" there must be a fee paid, directly or indirectly, to the franchisor.[52] Franchise fees are defined as an amount required to be paid to secure the right to enter business under the franchise agreement, with three exceptions:

> (1) the purchase or agreement to purchase goods at a bona fide wholesale price;
> (2) the payment of a reasonable service charge to the issuer of a credit

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[49] *Id.*

[50] One commentator defines a franchise as:

> [A] contractually integrated system of marketing and distribution of a product, defined as goods, services, or a way of doing business . . . whereby a franchisor who has developed a successful, accepted product and business format for his type of business, then contracts with independent, relatively similar business men (franchisees), giving them, for a fee, the right and license to sell this product, and subsequently assisting them in selling this product to the public . . . the franchisor should, and usually does, train the franchisee in the . . . operation of the business, and maintains and agrees to maintain continuing interest and assistance.

FELS, FRANCHISING: LEGAL PROBLEMS AND THE BUSINESS FRAMEWORK OF REFERENCE —AN OVERVIEW 9, 10 (J. McCord & I. Cohen, Eds. 1968).

[51] S.B. 295 § 1705.01(D). This definition is identical to the California provision. CAL. CORP. CODE § 31005 (West Supp. 1971).

[52] S.B. 295 § 1705.01(D).

card by an establishment accepting or honoring such credit cards; and

(3) amounts paid to a trading stamp company by a person issuing trading stamps in connection with the retail sale of merchandize or service.[53]

This definition of "franchise fee" effectively prevents the application of S.B. 295 to the typical distributor-retailer arrangements, regardless of whether the parties use the term "franchise" in their agreement, because the agreement typically provides only for the purchase of goods at a true wholesale price. There will no doubt be cases where the franchisor attempts to avoid the reach of the disclosure bill by foregoing any formal franchise fee. If the franchisor obtains revenue from the franchisee in the form of inflated prices for goods in exchange for the franchise license, the franchisor should be subject to S.B. 295, since, in effect, he has received a payment for the right to enter business under the franchisor's plan. The exception for the purchase of goods at a bona fide wholesale price would not exempt the franchisor in such a case from the disclosure provisions, but the enforcement of this provision will be difficult. Franchisor schemes to avoid this section of S.B. 295 should be considered in substance rather than form. Only in this way could the proper meaning and purpose of the statute be effected.

The exemption provisions of S.B. 295 further narrow the application of the proposal. First, the Division of Securities may declare a franchise exempt if the Division finds that the registration is not necessary to protect the investor-franchisee.[54] What is intended by this exemption is not entirely clear. It could be viewed as a "safety valve" to provide a means for declaring exemptions of new marketing systems which may literally fall within the jurisdiction of the statute, but may not be of a type which the Division believes should be regulated. This *discretionary* exemption power should be used sparingly, since the statute itself established certain exemptions deemed desirable by the legislature.[55]

Franchisors which meet minimum financial requirements[56] are exempt from registration, but not disclosure, if they also have at least 25 franchisees prior to the offer of sale[57] and disclose the specified information.[58]

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[53] S.B. 295 § 1705.01(E).

[54] S.B. 295 § 1705.05(C). The burden of proving an exemption in any proceeding based on the Ohio franchise disclosure law is on the person claiming it. S.B. 295 § 1705.36. An alternative is to require the person seeking an exemption to present evidence in support thereof prior to selling within the state.

[55] The Division of Securities would presumably consult the legislature if major exemptions were to be proposed by administrative rule.

[56] S.B. 295 § 1705.04(A). The franchisor must have a net worth of at least $5,000,000 to be exempt. If the franchisor is owned by a corporation having a net worth of at least $5,000,000, then the franchisor must have a minimum net worth of $1,000,000 to be exempt.

[57] S.B. 295 § 1705.04(B). The parent or subsidiary franchisor must have at least 25 franchisees which have conducted business for at least five years preceding the offer of sale.

The exemptions are based on the belief that established franchisors will have available assets if the franchise goes sour, and will also have the needed expertise to aid the franchisee in the initial establishment of the business. S.B. 295 also specifically exempts any bank credit card plans if a regulated bank carries the accounts[59] and any sale by a franchisee for his own account.[60]

The exemption provisions differ from those proposed in Massachusetts bill entitled the "Franchise Fair Dealing Act."[61] This proposal does not exempt the large, well-established franchisors. The Massachusetts bill would exempt franchises where the franchisee derives less than twenty percent of his gross sales from the franchise business if such sales are less than $25,000.[62] The Ohio proposal is preferable if the reason to require registration is to protect the franchisee's investment in the form of the franchise fee. The Massachusetts proposal allows the franchisor to avoid registration where the franchisee's business is not significantly tied to the franchised product. Where the relative volume of sales produced from the franchise product is small or the franchise term is brief, the Massachusett's bill does not require registration. This is obviously designed to exempt the manufacturer who "franchises" many dealers who, in turn, sell many products in retail outlets. S.B. 295 could arguably be construed in the same manner where the sales volume from the franchised product is small, depending upon the interpretation of "business" as this term is used in the bill. At what point the franchisee's sales volume in the licensed product becomes his "business" is a question which remains unanswered. If the true purpose of franchise disclosure is to protect the unsophisticated, small franchisee, the bill should not exempt any franchisor offering a franchise to a potential franchisee-investor with a net worth of less than a set value.

The jurisdictional requirements of any proposed statute must be designed to insure the application intended. A close examination of the definitions and exemptions relating to the Ohio franchise disclosure proposal must be undertaken by the legislature. Although future litigation on the jurisdictional requirements of S.B. 295 cannot be averted, every effort should be made to limit the application of the statute to the intended class of franchisors. Perhaps this problem is more acute in Ohio legislation since the litigant rarely has access to legislative history. The franchisors and the Ohio Division of Securities, however, should be provided with

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58 S.B. 295 § 1705.04(C). Exempt franchisees qualifying under the financial exemption rules must disclose in writing, at least 48 hours prior to execution of the franchise contract, certain basic facts as outlined in S.B. 295 §§ 1705.04(C) (1)-(14).

59 S.B. 295 § 1705.05(A).

60 S.B. 295 § 1705.04(B).

61 Mass. S. 110 (1971).

62 *Id.* § 2.

the best possible guidelines so that the statute can be administered and enforced fairly.

C. *Disclosure Provisions*

In the absence of a specific exemption, it is made unlawful under S.B. 295 to offer or sell a franchise unless registered with the Division of Securities.[63] The registration application must include specified information concerning the franchisor's business.[64] It must also be accompanied by the proposed offering prospectus and any other disclosures the Division may require.[65] If the Division does not issue a stop order, the registration becomes effective after fifteen days.[66] The Division may issue a stop order in the three following situations:

(1) if there has been a failure to comply with the statute or any Division rule adopted pursuant to the statute; or
(2) if the offer or sale would constitute misrepresentation, fraud or deceit with respect to the purchaser; or,
(3) if any person identified in the application has been the subject of criminal prosecution, any agency action, or civil judgment, and the involvement of such person in the sale or management of the franchise creates an unreasonable risk to prospective franchisees.[67]

The Division of Securities does not make a determination that the proposal is fair to the prospective franchisee. The disclosure requirements are designed to give the prospective franchisee the opportunity to determine the fairness of the offer. The Division's authority is only to protect the prospective buyer from misrepresentation or fraud which makes this provision consistent with the policy of the Ohio securities laws.[68] In addition, the prospectus must recite that registration does not constitute the Division's approval or recommendation.[69]

The disclosure bill also gives the Division of Securities two practical means of protecting the prospective franchisee. Advertisements published in Ohio offering a franchise for sale must be filed with the Division for its review prior to publication.[70] The Division then is given the discretion to order that the franchise fee be escrowed or a surety bond furnished by the franchisor, if it is found that the applicant has failed to show adequate

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[63] S.B. 295 § 1705.03.

[64] *Id.* § 1705.06.

[65] *Id.* § 1705.07.

[66] *Id.* § 1705.12.

[67] *Id.* § 1705.11.

[68] OHIO REV. CODE ANN. §§ 1707.25-26 (Page 1964).

[69] S.B. 295 § 1705.07.

[70] *Id.* at § 1705.14. The Division will review the advertisement and, if found to be misleading, will notify the advertiser. S.B. 295 § 1705.15. If the advertiser violates the order by publishing, the Division may seek an injunction. S.B. 295 § 1705.21.

financial ability to fulfill his promises to provide land, equipment, or training to the franchisee.[71]

The disclosure requirements,[72] the heart of the proposal, are quite inclusive and are set out in Appendix A. Several of the requirements deserve discussion or explanation. Subdivision (I) requires (1) a statement of the franchise fee, (2) the proposed allocation of the proceeds and (3) the formula used to determine the fee if variations exist among franchisees. This requirement is designed to give the prospective franchisee information to determine what tangible benefits he will receive in the form of equipment, training, advertising and other promised consideration. The largest part of the fee generally is allocated to the intangible benefits, *i.e.* the right to do business under the franchisor's name.[73] If the franchisee is aware of the percentage of the fee designated "profit," he may have the opportunity to bargain over the amount of the fee. Disclosure is also necessary to allow the Division of Securities to determine if the fee should be escrowed for the buyer's protection.[74]

Subdivision (J) requires disclosure of any other fees, including royalties, which the franchisee must pay. This requirement should be interpreted as requiring disclosure of charges for rent, equipment, advertising and supplies. Franchisors have often charged exorbitant prices for supplies,[75] and this provision will put the prospective franchisee on notice of the approximate costs of operating the business.

Subdivision (K) requires disclosure of conditions upon which the franchisor may terminate, refuse to renew or repurchase a franchise contract. In the absence of a statute regulating terminations, the franchisor has often been permitted to terminate the franchise without cause subject

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[71] *Id.* § 1705.10. A New York proposal suggested that all fees paid by the franchisee were to be held in trust until actually used to establish the franchise. New York S.B. 2321. Another proposal would require a mandatory $5,000 bond to be filed with a state agency. Minn. S.B. 1595.

[72] S.B. 295 § 1705.06.

[73] *See* E. LEWIS & R. HANCOCK, THE FRANCHISE SYSTEM OF DISTRIBUTION 21, 28-31 (Univ. of Minnesota 1963), reprinted in *Hearings on S. Res. 40 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong., 1st Sess. (1965). [hereinafter cited as LEWIS & HANCOCK].

[74] S.B. 295 § 1705.10.

[75] BROWN, *supra* note 9, at 15-16. *See* Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1971), *cert. denied*, 405 U.S. 955 (1972). In *Siegel*, franchisees sought treble damages for excessive charges for equipment and supplies they were required to buy under the franchise agreement. The Ninth Circuit held that the contract constituted an illegal tying arrangment in violation of the Sherman Act. The case was remanded to determine certain factual issues relating to damages. The federal district court had previously granted relief to the plaintiff franchisees. Siegel v. Chicken Delight, Inc., 311 F. Supp. 847 (N.D. Cal. 1970).

Another problem area has been discrimination between franchisees with respect to the amounts charged for equipment, supplies and royalty payments. At least two proposals have contained clauses dealing with such discriminations. *See* Washington S.B. 755 § 18(1)(C) (1971) and Arkansas Act No. 252 § 2 (1971). The Arkansas enactment simply prohibits royalty fees charged Arkansas franchisees from exceeding royalties charged franchisees in other states.

only to liability for antitrust violations.[76] It should be noted that S.B. 295 does not attempt to regulate the termination in any manner since the disclosure bill is directed only at the initial sale of the franchise.

Subdivision (L) requires disclosure of whether the contract requires the franchisee to buy supplies or equipment from the franchisor organization. Product purchase agreements, required by the franchisor as a condition precedent to the sale of the franchise license, are extremely vulnerable to antitrust attacks as illegal tying arrangements under the Sherman Act.[77] Although S.B. 295 does not purport to influence developing antitrust law, subdivision (L) will alert the prospective franchisee to the franchisor's policy regarding the purchasing of commissary supplies and necessary equipment. Two recent cases provide the franchisee with an idea of what kind of tying arrangements will be permitted within the antitrust laws. In *Susser v. Carvel Corp.*,[78] the Second Circuit Court of Appeals upheld a tying arrangement where franchisees were required to purchase ice cream mix from the franchisor. The *Susser* court accepted the following franchisor justifications for the tie-in purchase requirements: control of product quality, maintenance of a secret ice cream formula, and possible tort liability of the franchisor for harmful ingredients. The courts may also accept the justification that the franchisor is relatively new in the business and that alternate suppliers are not available.[79] A more recent deci-

[76] *See* text accompanying notes 103-58 *infra.*

[77] Tying arrangements are vulnerable to attack under § 1 of the Sherman Act, 15 U.S.C. § 1 (1964), § 3 of the Clayton Act, 15 U.S.C. § 14 (1964), and under § 5 of the FTC Act, 15 U.S.C. § 45 (1964). Earlier cases seem to adopt a per se approach to tying arrangements. Today, howver, the possibility of establishing a justification, appears to relax the per se approach, if not abrogate it entirely. In International Salt Co. v. United States, 332 U.S. 392 (1947), Mr. Justice Jackson stated in his majority opinion that "it is unreasonable, *per se*, [*sic*] to foreclose competitors from any substantial market." *Id.* at 396. Eleven years later the Court qualified the strict per se approach. Writing for the majority in Northern Pacific R. Co. v. United States, 356 U.S. 16 (1958), Mr. Justice Black found tying arrangements to be

> unreasonable in and of themselves whenever a party has sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product and a "not insubstantial" amount of interstate commerce is affected.

In 1963, Mr. Justice Douglas observed in his majority opinion that tying arrangements "may fall" in the category of per se violation, "though not necessarily so." White Motor Co. v. United States, 372 U.S. 253, 262 (1963). *White Motor* was primarily a territorial restriction case; the principle involved, however, is clearly analagous. For a discussion of the antitrust implications of franchise tying devices, *see* McCarthy, *Trademark Franchising and Antitrust: The Trouble with Tie-ins*, 58 CALIF. L. REV. 1085 (1970); Rudnick, *The Franchisor's Dilemma: Can He Satisfy the Legal and Commercial Requirements of a Trademark Licensing System Without Exposing Himself to Other Legal Risks*, 56 TRADEMARK REPTR. 621 (1966); Turner, *The Validity of Tying Arrangements Under the Antitrust Laws*, 72 HARV. L. REV. 50 (1958); Note, *Business Justification for Tying Agreements: A Retreat from the Per Se Doctrine*, 17 W. RES. L. REV. 257 (1965).

[78] 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965).

[79] *See* United States v. Jerrold Electronics Corp., 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961). *See also* Note, *Newcomer Defenses: Reasonable Use of Tie-Ins, Franchises, Territorials, and Exclusives*, 18 STAN. L. REV. 457 (1966).

sion, however, suggests that franchisors may now face a heavier burden in justifying tying arrangements. In *Siegel v. Chicken Delight, Inc.*,[80] the Tenth Circuit Court of Appeals refused to condone a tying arrangement requiring fast-food franchisees to purchase a specified number of fryers, cookers, packaging supplies, and mixes. The *Siegel* decision relied upon a United States Supreme Court decision for the test to be applied to determine the legality of tying the purchase of supplies to the franchise license.

> [T]he protection of the good will of the manufacturer of the tying device —fails in the usual situation because specification of the type and quality of the product to be used in connection with the tying device is protection enough. . . . The only situation, indeed, in which the protection of good will may necessitate the use of tying clauses is where specifications for a substitute would be so detailed that they could not practicably be supplied.[81]

The jury in *Siegel* found that effective quality control was possible by specification for the cooking equipment and the spice mixes. The court determined as a matter of law that specification of the packaging materials was possible after the defendant decided not to contest this issue. Thus, the designation of alternate suppliers in the usual case will fulfill the franchisor's legitimate desire to maintain a uniform quality.[82] Only in limited circumstances should the courts allow the franchisor to justify schemes which tie products furnished by the franchisor organization to the franchise license or trademark.

Subdivision (P) requires disclosure of any projected franchisee earnings reports and data supporting these estimates. Advertisements offering franchises for sale are often misleading on this point.[83] It is obvious that new franchise locations may not produce the same profit figures as an established franchise in a prime location.[84] The data furnished by the franchisor

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[80] 448 F.2d 43 (9th Cir. 1971), *cert. denied*, 405 U.S. 955 (1972). Two distinct products are necessary for a tying arrangement. Times-Picayune Publishing Co. v. United States, 345 U.S. 594, 613-614 (1953). The two distinct products in the typical franchise system are the franchise trademark and the operational supplies. Siegel v. Chicken Delight, Inc., *supra* notes 47-48.

[81] Standard Oil of Calif. and Standard Stations, Inc. v. United States, 337 U.S. 293, 306 (1949).

[82] It is submitted that the result in *Susser* is the exception to the rule expressed in *Standard Oil of Calif.* The recent *Siegel* decision raises serious doubts as to whether franchisors can place much reliance upon the *Susser* opinion. *See* Note, *Tying Arrangements Under the Antitrust Laws: The "Integrity of the Product" Defense*, 62 MICH. L. REV. 1413 (1964); Comment, *Franchises, Requirements Contracts and Tie-ins: One Test for a Tangled Two*, 74 YALE L.J. 691 (1965).

[83] *N.Y. Att'y Gen. Rep.*, *supra* note 9, at 9-10. *Contra* LEWIS & HANCOCK, *supra* note 73, at 81: "Only a few franchisees felt that they had been 'oversold' on the business by a glowing profit picture painted by the franchisor."

[84] *See Interim Hearing*, *supra* note 9, at 130. The California Department of Corporations has exercised its authority to issue rules under CAL. CORP. CODE § 31502 (West Supp. 1971). The rule relating to franchisee earnings projections simply states:

> Where projected or estimated franchisee earnings are proposed to be used such projected or estimated earnings together with a statement setting forth the data

should be reported in a mode offering a meaningful breakdown of profit projections for reasonable classifications of franchisees. Classifications could be prescribed by the Division of Securities based upon location, size and length of operation. The aim should be to provide the prospective franchisee with realistic data without guaranteeing any level of sales or earnings. Aggregating the performances of individual franchisees, even assuming that reasonable classifications are devised, will never be a totally accurate guide to the prospective buyer. What can be accomplished under a system of reasonable classifications is to foreclose the possibility that the franchisor will make earnings projections completely devoid of factual support.

Subdivision (S) pertains to disclosure of exclusive territory agreements. The franchisee does not want to compete directly with other franchisees or the franchisor's self-owned units. The limiting factors here are the antitrust laws which may require the franchisor to show justification for territorial restraints.[85] The disclosure provision of this subdivision is merely intended to put the prospective franchisee on notice of the franchisor's policy of granting or not granting territorial rights. The disclosure will serve as evidence of the franchisor's representation to the franchisee if later disputes concerning territorial rights arise.

D. *Remedies Available to the Franchisee*

In addition to possible criminal liability,[86] S.B. 295 creates a civil remedy for the injured franchisee or prospective franchisee for certain enumerated unlawful acts. This gives the franchisee a cause of action for damages and, if the violation is willful, recission may be granted.[87] The prohibited practices are five in number:

(1) willfully making an untrue statement or omitting a required statement of a material fact in any application or report;
(2) selling a franchise in Ohio by means of any misleading statement or omission outside the application or prospectus;
(3) violating any order of the Division of Securities;
(4) making any representation that the Division of Securities has endorsed the offer; and
(5) in the case of exempt franchisors, willfully making or omitting any material fact as required to be disclosed under § 1705.04.[88]

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upon which such estimation or projection is based should be included in the offering prospectus, to the extent the projections are generally applicable to all franchisees. RELATED RULES OF FRANCHISE INVESTMENT LAW § 310.114.2(16) (1971). Whether this rule will be effective in forcing the franchisors to offer meaningful data remains to be seen.

[85] *See* United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967); United States v. Sealy, Inc., 388 U.S. 350 (1967); White Motor Co. v. United States, 372 U.S. 253 (1963). One proposed disclosure law prohibits the franchisor from competing in the relevant market area with its own franchisees. Washington S.B. 755 § 755.18 (1)(f) (1971).

[86] S.B. 295 § 1705.99.

[87] S.B. 295 § 1705.22.

[88] S.B. 295 § 1705.16. The exempt franchisor must still disclose certain facts to the fran-

The principal remedy for franchisees for deceptive practices traditionally has been an action for fraud.[89] S.B. 295 seems to parallel the fraud remedy although it may be easier for the franchisee to prevail in cases of willful omissions. A recovery of attorney fees should be considered as an additional aid to the defrauded franchisee.[90]

The franchisor is also liable in damages to the franchisee for failure to file an application for registration or failure to disclose any statement specifically required by S.B. 295. Willful failure to comply will also allow the franchisee to sue for rescission.[91] Many franchisors may be judgment proof when the franchisee sues for damages.[92] S.B. 295 gives the plaintiff an extended range of defendants from which to collect by imposing joint and several liability on partners, officers, or directors of the franchisor.[93] This provision is in line with the purpose of providing the "duped" franchisee with restitution of his investment.

IV. Substantive Legislation Beyond Disclosure

Disclosure legislation is designed to correct abuses at the entry point. After the franchise agreement is executed, different types of abuses and problems arise. The franchisee, of course, is put on notice by the disclosure that the franchisor may plan to follow certain policies, but the franchisor may ignore his previous representations. Nor is the fairness of the franchisor's policies determined by disclosure. As a result, two major problem areas can be discerned: (1) termination of the franchise relationship, and (2) the superior bargaining position of the franchisor. The termination situation has received considerable legislative attention; unlike the inequalities of bargaining power which have been shown most clearly in antitrust suits. The legislative response to the unfair bargaining position has come in the form of proposals for collective bargaining or arbitration.

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chisee, and disclosure must be made at least 48 hours prior to execution of the franchise contract. S.B. 295 § 1705.34.

[89] Brown, *supra* note 9, at 35-38. *See, e.g.*, Hartong v. Partake, Inc., 266 Cal. App. 2d 942, 72 Cal. Rptr. 722 (1968).

[90] *See* Oregon H.B. 1497 § 5 (1971), which allows the recovery of attorney fees.

[91] S.B. 295 § 1705.22. The franchisor may have a defense under this section if he proves that the franchisee knew of the untruth or omission. The franchisor may also assert as a defense that he did not know of the untruth and would not have known if he had exercised reasonable care.

[92] The statute of limitations for actions based on failure to file registration or to disclose required information is: (a) four years, or (b) one year after discovery by the plaintiff, or (c) ninety days after written notice of a violation given by the franchisor to the franchisee, whichever occurs first. S.B. 295 § 1705.22. For actions grounded on misleading statements outside the registration area, the statute of limitations substitutes a two year maximum but is otherwise identical. S.B. 295 § 1705.23.

[93] S.B. 295 § 1705.24.

A. *Legislation Affecting Bargaining Position*

The Massachusetts "Franchise Fair Dealing Act," introduced in 1971,[94] contains two provisions to help equalize the bargaining position. One section allows franchisees to associate for collective bargaining purposes:

> Franchisees shall have the right to select a collective bargaining agent of their own choosing to negotiate and deal with franchisors and subfranchisors on matters having to do with their franchise relationship.[95]

Under this proposal the franchisor is obligated to bargain with the selected agent.[96] Arbitration is the alternative method of equalizing the disparity in bargaining position under the Massachusetts proposal, and the parties are permitted to provide compulsory binding arbitration clauses in the franchise contract.[97]

The collective bargaining provision would give the franchisees, as a class, power to bargain in many crucial areas. The pricing of necessary supplies and equipment is the most obvious and perhaps the most important for the franchisees, but a wide range of franchisor practices and policies would be subject to the bargaining.[98] Th ecollective bargaining provision is a realistic alternative for settling disputes as opposed to the class action suit which may destroy the franchisor organization financially. The class action would also consume a great amount of time before a remedy is available; both sides may be financially destroyed before the court order is final.

However, there are two major drawbacks to the collective bargaining approach. First, it may be unlawful under the antitrust laws. The federal antitrust laws specifically exempt labor collective bargaining from their application,[99] and without such an exemption the bargaining arrangement may be construed as an illegal group boycott.[100] The second drawback is that collective bargaining may disrupt the franchise relationship. Ideally, the franchise arrangement is a joint business venture, since both parties must rely on each other for ultimate success of the enterprise. In recognition of the defects of collective bargaining, one legislative proposal would establish a "mutual fiduciary obligation" between the franchise parties based upon agency concepts.[101] This approach has basic shortcomings because of the very nature of a fiduciary duty. The essence of a fiduciary

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94 Mass. S. 110 (1971).

95 *Id.* § 6(b).

96 *Id.* § 6(c).

97 *Id.* § 7(c).

98 *See* BROWN, *supra* note 9, at 92-93.

99 15 U.S.C. § 17 (1964).

100 *See* Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959).

101 Texas H.B. 709 (1971). This bill is termed the Texas Franchise Association Act. A similar provision was included in the Texas Franchise Investment Act, H.B. 405 § 9(17), 62d Legis., Reg. Sess., 1971.

relationship is that the fiduciary is to prefer another party's interests to his own private interests. The franchisee and franchisor are dealing at arms length and have assumed their respective positions as a result of contract negotiation. If one considers the franchise fee an investment, then it is conceivable to impose a fiduciary duty on the franchisor just as the law places a fiduciary duty on the director of a corporation. To develop a basis for imposing a fiduciary standard on the franchisee, however, is not so simple. If mutual obligations were imposed, the result may be a situation where two parties are striving to prefer the other's interests over their own, with the final result that both parties suffer.

Compulsory arbitration may prove to be a satisfactory method of solving contract disputes so long as the method of arbitration is fair. The Massachusetts arbitration provision would not foreclose the franchisee's right to bring suit based upon violations of the Act.[102] Thus, disputes over prices and business policies could be arbitrated, while the franchisor would still subject to suit based upon violations of statutory duties. The arbitration would only operate within the bonds of the contract itself. The drawback is that the individual franchisee cannot afford the same legal or financial experts that the franchisor has available for arbitration. The franchisee needs a system which provides arbitration assistance to a collective group of franchisees with similar problems.

The problems encountered by the franchisee during the contract term are substantial enough to warrant legislative protection. Each state legislature should closely consider the alternatives available or design new methods to solve the problems created by the disparate powers of the parties.

B. *Protection from unjust termination*

The franchise termination clause, an almost universally included provision in the franchise contract, is a constant threat to the franchisee. The most common termination clause provides that the franchisor may cancel for *any failure by the franchisee* to comply with the franchisor's standard procedures of operation.[103] Some contracts provide for termination at the *will of the franchisor*.[104] The franchisor can easily include many detailed operation procedures in the contract which may be virtually

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[102] The Massachusetts provision provides:

> With regard to disputes which arise after commencement of a franchise, the parties may provide for compulsory arbitration with the decision to be final and binding provided that the manner of selecting arbitrators, the time and place of arbitration, the sharing of expenses of arbitration, and the procedures are fair and reasonable . . . and provided further, that in such arbitration proceedings, the franchisee shall be entitled to the same procedural and substantive rights as those set forth in this Act . . . .

Mass. S. 110 § 7(c) (1971).

[103] BROWN, *supra* note 9, at 26-27.

[104] *Interim Hearing*, *supra* note 9, at 176 (testimony of Harold Brown).

impossible to comply with. Such clauses make many franchise contracts terminable at will for all practical purposes. Franchisees may be forced to give up a considerable degree of control over their investments in an attempt to comply with the franchisor's strict requirements. Absent statutory regulation, the courts have generally permitted the franchisor to terminate unilaterally or to refuse renewal[105] of the franchise if such action was unrelated to antitrust violations.[106] The basis of such decisions has often been the doctrine of freedom of contract; however, this common law right to terminate, or to refuse to renew, the contract is being seriously questioned in the area of franchising.[107]

Dissatisfaction with the franchisee's operation or business practice has been the strongest ground for termination and the courts have permitted such action where the complaints were legitimate.[108] More flagrant terminations, however, have also received judicial approval in the past. One court permitted termination where the franchisor was acquired by a company which already had its own distribution channels, and, therefore, had no need to maintain the existing franchisee operations.[109] In yet another termination case, the court held that termination of a franchise was proper where the franchisor had decided to grant an exclusive territory to another franchisee in the same geographical area.[110] Even where there is a justification for the termination, a proper concern of the court should be to insure that the franchisee receives a fair value for his investment. Where the termination itself is not contested by the franchisee, an equitable payment for any assets exchanged (including goodwill contributed by the franchisee) and just compensation for any rights forfeited by the franchisee should be required. Unfortunately, this is often not the case.[111]

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[105] Most franchises are granted for a specified time period and are subject to renewal. LEWIS & HANCOCK, *supra* note 73, at 60-62. *See* Bushwick-Decatur Motors v. Ford Motor Co., 116 F.2d 675 (2d Cir. 1940), holding that an automobile dealership contract which could be terminated by either party at will gave the manufacturer the unqualified power to terminate the contract regardless of good faith. The automobile dealers have since received legislative protection to prevent such action by the manufacturers. *See* text accompanying notes 117-22 *infra*.

[106] United States v. Colgate & Co., 250 U.S. 300 (1919). The franchisor was permitted to terminate out of "sheer perversity" in Lowe's, Inc. v. Somerville Drive-In Theatre Corp., 148 A.2d 599 (N.J. Super. Ct., App. Div., 1959).

[107] *See* Gellhorn, *Limitations on Contractual Termination Rights—Franchise Cancellations*, 1967 DUKE L.J. 465.

[108] Interborough News Co. v. Curtis Publishing Co., 255 F.2d 289 (2d Cir. 1955); Hudson Sales Corp. v. Waldrip, 211 F.2d 268 (5th Cir.), *cert. denied*, 348 U.S. 821 (1954).

[109] Bender v. Hearst Corp., 152 F. Supp. 569 (D. Conn. 1957), *aff'd*, 263 F.2d 360 (2d Cir. 1959).

[110] Packard Motor Car Co. v. Webster Motor Car Co., 243 F.2d 418 (D.C. Cir. 1956), *cert. denied*, 355 U.S. 822 (1957); Schwing Motor Co. v. Hudson Sales Corp., 138 F. Supp. 899 (D. Md. 1956), *aff'd per curiam*, 239 F.2d 176 (4th Cir. 1956), *cert. denied*, 355 U.S. 823 (1957).

[111] Industrial Buildings Materials, Inc. v. InterChemical Corp., 437 F.2d 1336 (9th Cir. 1970); Ace Beer Distributors Co. v. Kohn, Inc., 318 F.2d 283 (6th Cir. 1963). The testi-

With little or no burden on the franchisor to show proper cause for a franchise termination, the franchisee has been left with the possibility of contesting the termination with antitrust theories. Thus, if the franchisee can prove that the termination or refusal to renew the franchise resulted from the franchisor's efforts to establish or maintain a monopoly,[112] or from an illegal conspiracy among several franchisors or among the franchisor and other franchisees,[113] the franchisee may recover treble damages in an antitrust action. A similar result would follow if the franchisee can establish that cancellation resulted from the franchisor's efforts to illegally maintain resale prices,[114] to effect or maintain tying arrangements,[115] or to prevent the franchisees from selling competing products or services.[116] The obvious shortcoming of the antitrust remedy is that the franchisee cannot afford the long and expensive antitrust litigation. Although the franchisee may use prior court determinations resulting from government prosecutions as *res judicata*, the franchise may not be a viable concern by the time the franchisee has recovered damages.

The problem of unjust franchise terminations has received consideration by legislators at the federal and state government levels. The

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mony of a beer distributor as to the effect of the termination of his franchise illustrates the problem:

> At the time of the cancellation I operated as two closed corporations, one owning real estate and motorized equipment, the other owning the inventory and related merchandizing equipment. In 1946 I started out with capital amounting to $10,000. At the time of cancellation the real estate corporation had a net worth of $200,000, and the distributing company one of $185,000. Over the last 10-year period of operation the net profits of the two corporations, plus the salaries I drew from them, averaged over $100,000 annually—that was before Federal taxes. With the cancellation I lost the right to sell a going business for a price which such earnings would [have] justified. Not only did I forfeit future earnings and good will value of the business, but I had also to accept a fire-sale valuation for real estate and equipment. Having single-purpose warehouses and equipment, I had no alternative but to accept. Otherwise, I would have been left with nothing more than two piles of brick mortar and a "junk" yard of motorized equipment.

Hearings on Distribution Problems Affecting Small Business Before The Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 89th Cong., 1st Sess., 526, 527 (1965).

112 Lorain Journal Co. v. United States, 342 U.S. 143 (1951); Eastman Kodak Co. v. Southern Photo Materials Co., 273 U.S. 359 (1927); National Screen Service Corp. v. Poster Exchange, Inc., 305 F.2d 647 (5th Cir. 1962).

113 Radiant Burners, Inc. v. Peoples Gas Light & Coke Co., 364 U.S. 656 (1961); Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959).

114 Albrecht v. Herald Co., 390 U.S. 145 (1968); United States v. General Motors Corp., 384 U.S. 127 (1966); United States v. Parke, Davis & Co., 362 U.S. 29 (1960); Broussard v. Socony Mobil Oil Co., 350 F.2d 346 (5th Cir. 1965); George W. Warner & Co. v. Black & Decker Mfg. Co., 277 F.2d 787 (2d Cir. 1960).

115 Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965); Dehydrating Process Co. v. A. O. Smith Corp., 292 F.2d 653 (1st Cir. 1961), *cert. denied*, 368 U.S. 931 (1961); Englander Motors, Inc. v. Ford Motor Co., 267 F.2d 11 (6th Cir. 1959).

116 Federal Trade Comm'n v. Brown Shoe Co., Inc., 384 U.S. 316 (1966); Standard Oil Co. of California v. United States, 337 U.S. 293 (1949). *See also* Tampa Electric Co. v. Nashville Coal Co., 365 U.S. 320 (1961); Nelson Radio & Supply Co. v. Motorola, Inc., 200 F.2d 911 (5th Cir. 1952), *cert. denied*, 345 U.S. 925 (1953).

first legislation enacted was the Automobile Dealer Franchise Act.[117] This Act simply gives the automobile dealer the right to institute suit in a federal district court to recover damages and attorney fees if the automobile manufacturer did not "act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, cancelling, or not renewing the franchise. . . ."[118] The burden of establishing a lack of "good faith" is placed on the dealer-franchisee.[119] Because of the difficulty of proving bad faith,[120] the automobile dealers have not been very successful in suits under this act.[121] The act also fails to provide the dealer with a recovery for "goodwill" which may exist at termination.[122]

The New York state legislature attempted to strengthen the automobile dealer's situation by replacing the "good faith" test[123] of the Automobile Dealer's Franchise Act with a test of "good cause,"[124] thereby placing a greater burden on the manufacturer. The proposed bill also provided for a mandatory injunction to prevent termination of the dealer franchise during litigation.[125] This injunction provision is crucial to the dealer. Without an injunction to prevent termination, the dealership is placed in jeopardy of failing before the litigation ends. This proposal, however, was vetoed by the Governor of New York.[126] Most states have not enacted legislation in this area, probably because they have believed the federal legislation[127] to be sufficient to protect the interests of the automobile dealers.

The most discussed proposal to regulate franchise termination in recent years was the Fairness in Franchising Act[128] introduced in 1969, by

117 15 U.S.C. §§ 1221-25 (1970).

118 15 U.S.C. § 1222 (1970).

119 Milos v. Ford Motor Co., 317 F.2d 712, 718 (3d Cir. 1963).

120 The courts have required a showing of coercion or intimidation on the part of the manufacturer. *See* Woodward v. General Motors Corp., 298 F.2d 121, 128 (5th Cir.), *cert. denied*, 369 U.S. 887 (1962); H.R. REP. No. 2850, 84th Cong., 2d Sess. 9 (1956).

121 BROWN, *supra* note 9, at 81. In the first 91 cases under the Act, only one franchisee award was upheld on appeal.

122 Pierce Ford Sales, Inc. v. Ford Motor Co., 299 F.2d 425 (2d Cir. 1962).

123 15 U.S.C. § 1222 (1964).

124 New York S.B. 4915 § 2 (1969).

125 *Id.* § 3.

126 CONTINENTAL FRANCHISE REV., July 28, 1969, at 7.

127 15 U.S.C. § 1221-25 (1970).

128 S. 1967, 91st Cong., 1st Sess. (1969) . The Hart Bill was not the first congressional attempt to aid the franchisee in his fight against termination by the franchisor. *See* H.R. 13628, 91st Cong., 1st Sess. (1969); H.R. 12490, 91st Cong., 1st Sess. (1969); H.R. 2818, 90th Cong., 1st Sess. (1967); H.R. 11972, 89th Cong., 2d Sess. (1966); H.R. 10113, 89th Cong., 1st Sess. (1965). The Hart Bill was first introduced as S. 2321, 90th Cong., 1st Sess. (1967), and was later redrafted and introduced as S. 1967 after Congressional hearings. *Hearings on Economic Concentration Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 90th Cong., 1st Sess. (1967). The original Hart Bill provided that the terminated franchisee could sue for damages if the franchisor did not pay the

Senator Hart. Unlike the previous federal legislation,[129] the Hart Bill was not limited to the automobile industry. More importantly, the Hart Bill placed the burden of proof on the franchisor to establish that the cancellation was for good cause.[130] Under the earlier Automobile Dealer Act, the franchisee has to establish "bad faith" on the part of the manufacturer and "bad faith" was interpreted as meaning "coercion or intimidation."[131] Thus the defendant franchisor would have a greater burden to meet under the Hart Bill.

Unlike the proposed New York bill,[132] the Hart Bill did not provide for a mandatory injunction to foreclose immediate termination of the franchise. Federal courts, however, will issue injunctions where the franchisee shows that he may possibly prevail over the franchisor at trial.[133] A mandatory injunction seems to be the better solution. The franchisee must be given time to use discovery in order to show cause to the federal court to issue an injunction pending the conclusion of the ligitation. The Hart Bill also provided that the franchisor give at least ninety days advance notice of termination. Although this provision has been criticized as unworkable[134] and of no aid to either party,[135] it would give the franchisee time to institute his suit and to start discovery to develop facts to warrant an injunction to prevent termination after the ninety day waiting period ends. It also gives the franchisee some time, although inadequate, to wind up his affairs by collecting receivables and depleting existing inventories.

Although the main thrust of the Hart Bill was to protect the franchisee from unfair terminations, the Act also prohibited a franchisor, in relation to the franchisee, from engaging in any acts of unfair competition as defined by § 5 of the FTC Act.[136] This provision broadens the scope of the franchise regulation, but it is too vague as written. Section 5 of the FTC

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franchisee a reasonable price for the franchise, including good will and any property involved. The franchisee was also given a cause of action if the termination was not due to the franchisee's "conscious malfeasance or willful failure . . . to perform adequately, competently and in good faith the lawful duties imposed upon him by the franchise contract." S. 2321 90th Cong., 1st Sess. (1967).

[129] 15 U.S.C. § 1221-25 (1970).

[130] S. 1967, 91st Cong., 1st Sess. § 4 (1969). The Automobile Dealer Franchise Act, 15 U.S.C. § 1221-25 (1964), placed the burden on the franchisee to prove that the manufacturer had not acted in good faith. Thus the Hart Bill was similar to the New York proposal discussed at notes 124-25 *supra.*

[131] Milos v. Ford Motor Co., 317 F.2d 712, 718 (3d Cir. 1963).

[132] New York S.B. 4915 § 3 (1969).

[133] Semmes Motors, Inc. v. Ford Motor Co., 429 F.2d 1197 (2d Cir. 1970); Swartz v. Chrysler Motors Corp., 297 F. Supp. 834 (D.N.J. 1969). *See also,* Bergen Drug Co. v. Parke Davis & Co., 307 F.2d 725 (3d Cir. 1962).

[134] Letter from Paul Rand Dixon, Chairman of the Federal Trade Commission, to Senator James O. Eastland, Chairman of the Senate Committee on the Judiciary, October 6, 1969.

[135] Augustine & Hrusoff, *Franchise Regulation,* 21 HASTINGS L.J. 1347, 1369 (1970).

[136] 15 U.S.C. § 45(a) (1970).

Act is itself designed to prevent unfair methods of competition, and this section of the Hart Bill does not prosecute any conduct not already illegal. Thus, unless it is meant to give the franchisee damages for any violation of § 5, the Hart Bill merely superimposes another statute to make unfair trade practices unlawful.

While the Hart Bill was in commitee, a federal court considered the application of the Puerto Rican termination law.[137] In *Fornaris v. The Ridge Tool Co.*,[138] the terminated franchisee attempted to avail himself of the Puerto Rican statute which placed on the franchisor the burden of justifying the cancellation. The franchise contract had been executed prior to the enactment of the termination statute. The court held that retroactive application of the law was unconstitutional, but the issue of prospective application of the law was reserved. Thus, it is quite possible that termination legislation will not aid present franchisees.

Although the Hart Bill was not reported out of committee,[139] several states have either enacted or considered similar legislation. Delaware enacted the first state law to protect franchisees against unjust termination. The "Delaware Franchise Security Law,"[140] enacted in 1970, is not aimed at a specific industry, but like the Hart Bill is of general application to franchises. The Act applies to "franchise distributors" who are required to invest more than $100 to enter the franchise agreement.[141] The definitions provided in the Delaware law limit its application to the sale of products, thus excluding franchises offering services only.[142] The Delaware Act provides for damages and injunctive relief similar to the remedies found in the Hart Bill. Injunctive relief is available to the franchised distributor where the franchisor unjustly cancels, refuses to renew or threatens termination.[143] The statute leaves the determination of what is "unjust" entirely to the courts. This Act seems designed to prevent threatened terminations which can be used by a franchisor as a lever to coerce a franchisee. Other provisions, requiring ninety days notice of termination and placing the burden on the franchisor to justify cancellation, are identical to those found in the Hart Bill.

The proposed Massachusetts "Franchise Fair Dealing Act"[144] is a comprehensive bill providing in part for protective measures against unfair terminations. Section 5 specifically makes it unlawful to:

> harass, intimidate, or coerce a franchisee to enter into any agreement or to

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[137] 10 L.P.R.A. §§ 278a-d (Equity Supp. 1971).
[138] 423 F.2d 563 (1st Cir. 1970).
[139] CONTINENTAL FRANCHISE REV., June 1, 1970, at 2.
[140] 6 DELA. CODE ANN. §§ 2551-57 (West Supp. 1970).
[141] *Id.* § 2551.
[142] *Id.*
[143] *Id.* § 2553.
[144] Mass. S. 110 (1971).

> do or refrain from doing any other act prejudical to the franchisee or to accomplish such result by threatening to cancel or to fail to renew any franchise . . . provided, however, that notice in good faith of the franchisee's violation of any terms or conditions of such franchise or contractual agreement shall not constitute a violation hereof.[145]

Section 5 also makes it unlawful to terminate a franchise without "due cause" regardless of what the terms of the franchise contract provide.[146] The franchisor must notify the franchisee and the Attorney General in writing of termination sixty days prior to the effective date and must state the grounds for this action. During the sixty day waiting period, either party can petition the court for preliminary or final injunctive relief. Thus, the Massachusetts proposal is substantively similar to the Hart Bill's termination provisions.

A New Jersey enactment also attempts to solve the termination problem. The "Franchise Practices Act"[147] contains a 180 day notice provision and notice must be given regardless of the reason for termination or non-renewal of the franchise.[148] "Good cause" is the franchisor's only defense for the termination action. The Act provides that good cause is limited to:

> failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise which requirements must be essential, reasonable and nondiscriminatory.[149]

This section makes it clear that unreasonable franchisee requirements provided in the contract, which may be impossible to fully comply with, will not be given effect.

The Ohio General Assembly recently enacted legislation to regulate the termination of automobile dealerships by manufacturers. Effective November 18, 1971, an automobile manufacturer cannot terminate a dealer franchise without the prior consent of the dealer for other than just cause.[150] This law provides that the court shall determine what constitutes "just cause" under the facts of the case. The court is not bound by the terms of the contract in its determination. The franchisee may petition the court for an injunction to prevent a threatened cancellation pending a hearing to establish cause.[151] Thus, the automobile dealer franchisee will be able to remain in business until the court disposition. The manufacturer's liability for an unjust termination, or a cancellation without cause,

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145 *Id.* § 5(b)(1).

146 *Id.* § 5(b)(2).

147 New Jersey Franchise Practices Act, N.J. REV. STAT. §§ 56:10-1—10-12 (West Supp. 1972).

148 *Id.* § 10-5.

149 *Id.*

150 OHIO REV. CODE ANN. § 1333.73 (Page Supp. 1971).

151 *Id.* § 1333.74.

is limited to the reasonable damages proximately caused by the unlawful action.[152] The statute also provides that the manufacturer shall purchase the dealer's assets for their full market value; no provision is made, however, for reimbursement for loss of goodwill. Franchisees, other than automobile dealers should be accorded at least the protection provided by the existing Ohio law regulating the termination of automobile dealerships.

The termination threat, when combined with the fact that the franchisor usually has a far superior economic position, may provide the basis for a coercive relationship.[153] Without the aid of specific legislation protecting the franchisee from unjust terminations, the franchisee may attempt to contest the cancellation on the ground that the contract clause allowing termination is unconscionable.[154] The franchisee's argument should be strenthened where the contract allows cancellation at will or for the violation of terms which are nearly impossible for any franchisee to comply with in full. Using the Uniform Commercial Code by analogy, the franchisee can present a strong case for enforcement of the franchise contract without the unconscionable termination clause.[155] Indeed, the Code suggests that reasonable notification of termination should be the very least the franchisee is entitled to.[156] Although advance notice may not be required in a situation where the termination is for just cause,[157] it seems equitable to grant the unjustly terminated franchisee a reasonable time to adjust to the cancellation even if he does not contest the franchisor's action.

The unconscionability argument, however, places a great burden on the franchisee-plaintiff. Only under extreme circumstances are courts willing to accept this argument as cause for altering written contracts.[158] To enforce the franchise contract and maintain the relationship, the court is ordering specific performance of the agreement. Without legislative authority granting the franchisee the right to seek specific performance of the franchise contract, the courts will probably be reluctant to grant this extraordinary remedy. Legislation similar to that now provided in Ohio to protect the automobile dealers would give other franchisees the statutory

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152 *Id.*

153 The FTC has prosecuted several cases involving the coercive use of economic power. *See, e.g.*, FTC v. Texaco, Inc., 393 U.S. 223 (1968); Atlantic Refining Co. v. FTC, 381 U.S. 357 (1965); Shell Oil Co. v. FTC, 360 F.2d 470 (5th Cir. 1966).

154 *See* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965); Campbell Soup Co. v. Wentz, 172 F.2d 80 (3d Cir. 1948); American Home Improvement v. MacIver, 105 N.H. 435, 201 A.2d 886 (1964).

155 UNIFORM COMMERCIAL CODE § 2-302(1) (1962 version) [hereinafter cited as U.C.C.].

156 *Id.* § 2-309(3).

157 *Id.* § 2-309, Comment 9.

158 In one recent case the franchisee asserted that the failure to renew a franchise at the end of a three year term without cause was unconscionable. The court disagreed and ruled in favor of the franchisor. Division of Triple T Service, Inc. v. Mobil Oil Corp., 60 Misc.2d 720, 304 N.Y.S.2d 191 (1969).

basis to contest the termination and seek to have the franchise upheld.[159] Franchisees relying directly on article 2 of the Uniform Commercial Code to protect their interest on termination will also face the burden of establishing that the Code applies. Although the sale of goods to the franchisee would qualify for article 2 treatment, the sale of the franchise right itself does not fit within the scope of the article. The comments to § 2-105, however, state that the provisions of article 2 may be analagous to the sale of investment securities.[160] Thus, the franchisee should be able to avail himself of the general policies of the article dealing with the sale of goods.[161]

V. CONCLUSION

Ohio S.B. 295 is a sound legislative response to a major problem facing the franchising system. Although a franchise may resemble a security in many ways, the abortive California attempt to utilize the state securities laws to require disclosure by franchisors is strong evidence that specific legislation is necessary to remedy the abuses in this area. The various proposals considered by the state and federal legislatures are substantively similar in respect to the items to be disclosed. The major differences in the statutes pertain to jurisdictional requirements and the enforcement and administration. A complicating factor at this time is the possibility of a federal act which preempts state legislation. Preemptive federal legislation, favored by the franchisors, has a great amount of merit. The major advantage to the franchisors is that they would be required to conform to only one regulatory scheme. The franchisees would also be benefitted by the enforcement expertise possessed by a federal administrative agency.

The FTC has taken a particularly active interest in franchise abuses. State legislation, however, can have a significant place in the overall regulatory program to require disclosure by franchisors if preemptive federal legislation is not enacted. For an effective scheme, however, the state legislation should conform closely to the federal program to provide a coordinated enforcement effort. For example, if the disclosure requirements are nearly identical, the states could easily accept copies of registration statements filed with the federal agency and thereby avoid unnecessary duplication of effort. The availability of the concurrent jurisdiction of state and federal agencies would provide an increased enforcement capability to the benefit of the franchisees. The federal agency may be better prepared to cope with the larger interstate franchisors while leaving the states to enforce disclosure by smaller intrastate franchisors. Considering

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159 OHIO REV. CODE ANN. § 1333.73-74 (Page Supp. 1971).

160 U.C.C. § 2-105, Comment 1.

161 *See* Comment, *Article Two of the Uniform Commercial Code and Franchise Distribution Agreements*, 1969 DUKE L.J. 959. The author discusses in the detail the possible application of article 2 to the sale of franchise rights.

the fate of previous federal proposals to regulate franchising, the states should not fail to enact adequate legislation to protect franchisees simply because there exists a possibility of federal preemptive legislation.

There seems to be no basis for not providing Ohio franchisees the protection from unjust terminations which is presently accorded automobile dealers. The threat of unjust terminations must be removed as the first step toward providing the franchisee with the ability to bargain with the franchisor on a more equal footing. The Ohio General Assembly should also consider legislation which encourages binding arbitration between franchisors and franchisee groups. Such legislation would provide the franchisees with the ability to adequately protect their interests.

Curtis A. Loveland

APPENDIX A

Set forth below is § 1705.06 of Ohio Senate Bill 295. This section contains the complete list of items required to be disclosed by franchisors under the proposed statute.

Sec. 1705.06. The application for registration of an offer shall be filed with the Division of Securities and shall contain the following:

(A) The name of the franchisor, the name under which the franchisor is doing or intends to do business, and the name of any parent or affiliated company that will engage in business transactions with franchisees.

(B) The franchisor's principal business address and the name and address of an agent authorized to receive process under Civil Rule 4.2.

(C) The business form of the franchisor, whether corporate, partnership, or otherwise.

(D) Such information concerning the identity and business experience of persons affiliated with the franchisor, as the Division may by rule prescribe.

(E) A statement whether any person identified in the application for registration:

(1) has been convicted of a felony or held liable in a civil action by final judgment if such felony or civil action involved fraud, embezzlement, fraudulent conversion or misappropriation of property; or

(2) is subject to any currently effective order of the Securities and Exchange Commission or the Securities Administrator of any state denying registration to or revoking or suspending the registration of such person as a securities broker or dealer or investment advisor or is subject to any currently effective order of any national securities association or national securities exchange suspending or expelling such person from membership in such association or exchange; or

(3) is subject to any currently effective order or ruling of the Federal Trade Commission; or

(4) is subject to any currently effective injunctive or restrictive order relating to business activity as a result of an action brought by any public agency or department, including without limitation, actions affecting a license as a real estate broker or salesman.

Such statement shall set forth the court, date of conviction or judgment, any penalty imposed or damages assessed, or the date, nature and issuer of such order.

(F) The length of time the franchisor has conducted a business of the type to be operated by the franchisees, has granted franchises for such business, and has granted franchises in other lines of business.

(G) A recent financial statement of the franchisor, together with a statement of any material changes in the financial condition of the franchisor from the date thereof. The Commissioner may by rule or order prescribe:

(1) the form and content of financial statements required under this section;

(2) the circumstances under which consolidated financial statements shall be filed;

(3) the circumstances under which financial statements shall be audited by independent certified public accountants or public accountants.

(H) A copy of the typical franchise contract or agreement proposed for use or in use in this state.

(I) A statement of the franchise fee charged, the proposed application of the proceeds of such fee by the franchisor and the formula by which the amount of the fee is determined if the fee is not the same in all cases.

(J) A statement describing any payments or fees other than franchise fees that the franchisee or subfranchisor is required to pay to the franchisor, including royalties and payments or fees which the franchisor collects in whole or in part on behalf of a third party or parties.

(K) A statement of the conditions under which the franchise agreement may be terminated or renewal refused, or repurchased at the option of the franchisor.

(L) A statement as to whether, by the terms of the franchise agreement or by other device or practice, the franchisee or subfranchisor is required to purchase from the franchisor or his designee services, supplies, products, fixtures or other goods relating to the establishment or operation of the franchise business, together with a description thereof.

(M) A statement as to whether, by the terms of the franchise agreement or other device or practice, the franchisee is limited in the goods or services offered by him to his customer.

(N) A statement of the terms and conditions of any financing arrangements when offered directly or indirectly by the franchisor or his agent or affiliate.

(O) A statement of any past or present practice or of any intent of the franchisor to sell, assign or discount to a third party any note, contract or other obligation of the franchisee or subfranchisor in whole or in part.

(P) A copy of any statement of estimated or projected franchisee earnings prepared for presentation to prospective franchisees or subfranchisors, or other persons, together with a statement setting forth the data upon which such estimation or projection is based.

(Q) A statement of any compensation or other benefit given or promised to a public figure arising, in whole or in part, from the use of the public figure in the name or symbol of the franchise or the endorsement or recommendation of the franchise by the public figure in advertisements.

(R) A statement of the number of franchises presently operating and proposed to be sold, as may be required by rule of the Division.

(S) A statement as to whether franchisees or subfranchisors receive an exclusive area or territory.

(T) Other information related to the application as the Division may reasonably require.

(U) Other information as the franchisor may desire to present.

(V) When the person filing the application for registration is a subfranchisor, the application shall also include the same information concerning the subfranchisor as is required from the franchisor pursuant to this section.